THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

TWO - Q4 2011 Two Harbors Investment Corp Earnings Conference Call

EVENT DATE/TIME: FEBRUARY 08, 2012 / 2:00PM GMT

©2012 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

THOMSON REUTERS

CORPORATE PARTICIPANTS

Christine Battist *Two Harbors Investment Corp. - Managing Director*

Tom Siering *Two Harbors Investment Corp. - President, CEO*

Jeff Stolt *Two Harbors Investment Corp. - Former CFO*

Brad Farrell *Two Harbors Investment Corp. - CFO*

Bill Roth *Two Harbors Investment Corp. - Co-Chief Investment Officer*

CONFERENCE CALL PARTICIPANTS

Mark DeVries *Barclays Capital - Analyst*

Jason Weaver *Sterne Agee - Analyst*

Trevor Cranston *JMP Securities - Analyst*

Bose George *KBW - Analyst*

Joel Houck *Wells Fargo - Analyst*

Boris Pialloux *National Securities - Analyst*

PRESENTATION

Operator

Good morning. My name is Kevin, and I will be your conference facilitator. At this time, I would like to welcome everyone to the Two Harbors Fourth Quarter 2011 Financial Results Conference Call.

All participants will be in a listen-only mode. After the speakers' remarks, there will be a question and answer period. I would now like to turn the call over to Christine Battist, Managing Director for Two Harbors.

Christine Battist - *Two Harbors Investment Corp. - Managing Director*

Thank you, Kevin, and good morning. Welcome to Two Harbors' fourth quarter 2011 financial results conference call. With me -- excuse me -- with me this are Tom Siering, President and Chief Executive Officer, Brad Farrell, Chief Financial Officer, Jeff Stolt, former Chief Financial Officer, and Bill Roth, Co-Chief Investment Officer.

After my introductory remarks, Tom will discuss our mission and strategic priorities. Then, Brad will highlight some key items from our financial results, and Bill will review our portfolio performance and provide an update on the deployment of capital from our recent secondary offering. The press release and financial tables associated with today's conference call were filed yesterday with the Securities and Exchange Commission. If you do not have a copy, you may find them on the Company's website at www.twoharborsinvestment.com.

This call is also being broadcast live over the internet and may be accessed on our website in the investor relations section under the events and presentation link. In addition, we'd like to encourage you to reference the accompanying presentation to this call, which can also be found on our website.

Before management begins its discussion of its fourth quarter results, we wish to remind you that remarks made by Two Harbors' management during this conference call and the supporting slide presentation may include forward-looking statements. Forward-looking statements reflect our views regarding future events and are typically associated with the use of words such as anticipate, target, expect, estimate, believe, assume, project, and should, or other similar words.

©2012 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

We caution investors not to rely unduly on forward-looking statements. They imply risks and uncertainties, and actual results may differ materially from expectations. We urge you to carefully consider the risks described in our filings with the SEC, which may be obtained on the SEC's website at www.sec.gov. We do not undertake any obligation to update or correct any forward-looking statements if later events prove them to be inaccurate. I will now turn the call over to Tom.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thanks, Christine. Good morning, and thank you to everyone for joining us today. Two Harbors had a great year in 2011, delivering a total return of over 12% on book value to stockholders. We performed well against a backdrop of a volatile market while, at the same time, advancing our strategic priorities, including diversifying our business model. While we are proud of our accomplishments in 2011, we look toward the upcoming year with more enthusiasm than ever.

We are well positioned in our portfolio, and we believe our expansion in the complementary business lines, which leverage our core strengths, including hedging and granular credit analysis, will benefit our shareholders. Brad and Bill will discuss our fourth quarter results and portfolio performance in greater deal.

I'd also like to spend some time talking about our recent strategic initiatives. For those of you with access to the slide presentation, please refer to slide three. Our mission is straightforward. We strive to deliver shareholder value and to be recognized as the best in class hybrid mortgage REIT. We believe we will achieve this goal through the combination of superior portfolio construction, unparalleled risk management, and leading governance and disclosure practices. We also believe the depth of our investment team is unmatched and that over the long run, we can mitigate risks, including volatility in interest rates, prepayments, and credit risks.

We view markets across sectors and deploy a fluid capital allocation model in pursuit of superior portfolio -- of -- in pursuit of a superior portfolio based upon a rigorous securities selection process. We are very proud that our net interest spreads and portfolio performance are amongst the best in the industry.

There are significant issues in the housing and mortgage markets that are yet to be resolved. Depressed home prices have prevented some home owners from refinancing, despite low rates, and left others with no option, but sadly, foreclosure. This confluence of events has resulted in a market standstill and a high inventory of vacant homes held by the government and banks.

In our view, uncertainty and anticipated change create opportunity. It will take some time for the housing and mortgage sectors to stabilize and gain footing. While there are no overnight remedies, nor can we predict the outcome of specific events, we embrace the opportunity to leverage Two Harbors' strengths to diversify our business.

The current interest rate environment is attractive for our business. Recently, the Fed announced that it anticipates keeping the targeted Fed funds rate low until at least late 2014. This benefits the funding of our assets for the next several years.

In the Agency sector, the long-term goal is for Fannie Mae and Freddie Mac to shrink their estimated $1.3 trillion portfolios by at least 10% annually, due to shifting regulatory and capital constraints. We believe Two Harbors will benefit from this reduced competition for Agency assets. As a hybrid REIT, we also invest in the non-Agency sector. We believe the non-Agency sector is attractive on both an absolute and relative basis and have been shifting our portfolio mix accordingly. Bill will elaborate on this in a bit.

Please move to slide four. On a strategic front, we took several important steps in 2011 to grow and diversify Two Harbors, starting with raising over $1 billion in capital, plus an additional $354 million in January, 2012. We are pleased to say that we have substantially deployed the capital from the January offering. Since our formation, we have increased our market capitalization over tenfold to nearly $1.8 billion today. We believe this demonstrates the market's confidence in our position and acumen. Importantly, we believe our shareholders have benefited from improved share liquidity, scale, diversified investor base, and lower expense metrics.

©2012 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

THOMSON REUTERS

Earlier in the year, we took the first step in diversifying our business model. In May, 2011, we announced our plan to start asset securitization program, targeting $250 million as our first securitization. As of yearend, we established the infrastructure and purchased our first loans. As we have said previously, we will draw on our strength in credit analysis for this program, and we'll continue to develop this business in an opportunistic manner.

Most recently, we announced a further diversification of our business model into single family residential properties. Slide five includes a summary of some key points regarding this new business. The opportunity exists to deploy capital into the dislocated residential market and acquire single family homes to rent them at attractive yields.

There are several dynamics that make this an interesting opportunity. Firstly, we believe single family realty today is an attractive asset class, given its long duration, low correlation to other traditional asset classes, its ability to be leveraged, and the potential for home price appreciation and increased rent.

Secondly, we intend to hold the properties we buy for investment and rent them for income. We are targeting properties at significant discounts to replacement cost. We believe this strategy will produce attractive return for our shareholders over time.

Thirdly, our strength lies in data and analysis in the housing finance markets. Two Harbors will oversee the allocation and deployment of capital in each of our targeted markets. We will use service providers for property acquisition and management services. This will include a combination of third parties and the newly formed affiliate of Pine River Capital Management to achieve efficiency and economies of scale.

Finally, we're taking a measured approach to the strategy. We do not expect this to represent a significant portion of Two Harbors' assets or to have a material impact on our results in the first quarter 2012. We will share more information on this new business in coming months.

So, suffice to say we've been busy. I'm proud of our accomplishments and want to thank our shareholders for their support. We could not have been what we are today without you. I will now turn the call to Jeff Stolt, who will introduce his successor, Brad Farrell, our newly appointed CFO, who will discuss the financial results for the quarter. This transition was previously announced in the fall and was made effective as of January 1, 2012. Jeff?

Jeff Stolt - *Two Harbors Investment Corp. - Former CFO*

Thanks, Tom. It has been a privilege to oversee Two Harbors finance and treasury teams since the Company's formation. Brad Farrell has been my right hand since the beginning and is my natural successor. It is my pleasure to congratulate him on the promotion to Two Harbors Chief Financial Officer. As for me, I will continue to serve as Partner and Chief Financial Officer of Pine River and look forward to continuing to work with the Two Harbors team. Brad, the floor is yours.

Brad Farrell - *Two Harbors Investment Corp. - CFO*

Thank you, Jeff, for that gracious introduction and the leadership you have demonstrated the past two and half years, I am extremely honored to become a member of Two Harbors executive team, and I look forward to serving our shareholders in 2012 and beyond.

This morning, I'd like to focus on three areas. I'll initially focus on the key drivers of our fourth quarter results and the change in equity. Then, share some insights on liquidity management, and finish with some comments on our 2011 taxable income.

Let's move to the financial summary on slide six. Core earnings are largely a function of our portfolio size, our investment spread, and our expense management. In all three cases, we have comparable metrics to the prior quarter. Our investment portfolio was $6.4 billion at December 31, 2011, comparable to where we ended the third quarter after the deployment of the proceeds from our July capital raise. Our investment spreads were consistent with our expectations, which Bill will expand upon in more detail. Finally, other operating expenses were in line with prior quarters at 1% of average equity.

©2012 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

Core earnings, a non-GAAP measure, represents a proxy for the earnings power of our portfolio. Core earnings per share has been stable, in the $0.40 range in the past three quarters. This quarter, core earnings represented a 17.4% return on average equity, 120 basis points higher than a quarter ago.

As a reminder, GAAP net income includes not only our core earnings, but also the impact of fair value changes on our hedging instrument and other than temporary impairments, both which can cause net income volatility quarter to quarter.

This quarter, fair value gains on swaps and swaptions were offset by fair value losses on credit default swaps, TBAs, and inverse IOs, which are all components of our overall hedging strategy. We had a minimal OTTI adjustment of $1.4 million this quarter, which reflects favorably on our securities selection and cash flow projections at time of purchase.

Slide seven contains sequential quarterly book value roll forwards that we believe are meaningful for investors. Our book value per share declined by $0.27 on a sequential quarter basis. This was driven by deterioration in our non-Agency fair values, partially offset by moderate fair value strengthening in our Agency strategy, net of hedges. Bill will expand upon the performance of each portfolio strategy in a few minutes.

Now, let's move on to the second topic, liquidity management. Although there are varying views about what impact the European debt crisis may have on US markets, the uncertainty continues to reinforce the need for liquidity management, including the effective management of counterparty risk and cash reserves. As of December 31, 2011, we had 20 financing counterparties. We utilized a diverse group of financing providers, and we will continue our practice of an ongoing assessment of their financial stability.

You may have noticed that cash on our balance sheet has grown from a year ago. This, combined with the strategic laddering of our repo maturities helps us sleep better at night. We continually monitor our excess liquidity and will maintain cash reserves, as appropriate, which provide a cushion against market shifts.

This brings me to taxable income. As you can see on slide eight, we reported $177 million in taxable income for 2011 within the REIT. This includes $8 million in earnings and profit generated in our taxable REIT subsidiary, or TRS, which was distributed through our REIT parent in the form of a dividend. The dividend from the TRS represents qualified dividend income, or QDI, which is taxed at a 15% rate for stockholders. As a REIT, we are required to distribute at least 90% of our taxable income to shareholders. I'm happy to report that we distributed 92% of taxable income to stockholders in 2011.

Finally, our dividend policy has not changed. As we have previously stated, we evaluate our dividend against a number of measures, including our ability to generate cash from our earnings to support our outgoing dividend stream. Now, I'll turn the call over to Bill.

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Thank you, Brad. I will first share some portfolio highlights from the quarter. Then we will move into a discussion about our recent capital deployment.

Our portfolio delivered another quarter of solid returns, as you can see from the highlights on slide nine. As a reminder, we had fully deployed our July capital raise by the start of the fourth quarter, so we were working off an asset base of approximately $6.4 billion. We believe our agility in adjusting our capital allocation to the best opportunity in the Agency and non-Agency sectors was a key factor in our performance this quarter.

The chart on the bottom left shows our portfolio metrics by strategy. Our aggregate net interest spread was 3.8%, 40 basis points lower than a quarter ago, but above our expectations at September 30. With our overall asset yield of 4.8% and leverage of 4.5 times, that still leads to an attractive investment return on equity. The decline in net interest spread was primarily due to a lower yield on our Agency strategy from lower yields on new investments and lower realized yields on IOs and Agency derivatives.

As you can see, our overall funding costs declined slightly from the third quarter, due to lower cost of hedging, although modestly higher repo rates in the fourth quarter slightly offset this benefit.

©2012 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

THOMSON REUTERS

Our non-Agency strategy delivered an annualized yield of 9.7% and a net interest spread of 7.5%. We are pleased with the robust yield, and it was in line with our expectations.

On our last earnings call, we indicated that we favored the non-Agency sector and intended to take advantage of the pullback in prices on these securities to add to our holdings. This has been and continues to be a good investment opportunity, and it has contributed nicely to our portfolio.

On the bottom right of slide nine, we've included some familiar indices to compare the performance of Two Harbors for 2011. A few numbers jump up -- jump out here. First, a simple Agency strategy on a hedge basis would have had a terrific one year return, while credit returns for the two indices shown definitely suffered badly. As I have mentioned in the past, ABX is a proxy for the subprime market, but it doesn't necessarily mirror cash bond performances.

Not shown here are index returns for financial stock and mortgage REITs, both which suffered negative total returns for the year. From this table, you can see that a simple strategy of 50% Agency and 50% non-Agency subprime, with returns of 17% and negative 25%, respectively, when combined, would have generated a negative 3.7% return for the year.

We believe that our opportunistic capital allocation approach and rigid security selection process led to our dramatic outperformance to these indices. We are very pleased with the delivering, a 12.6% return on book value to shareholders to -- during 2011.

Please turn to slide ten. Our portfolio composition was consistent in mix and type of securities with what we had at the end of the third quarter. We closed out 2011 with $5.2 billion in agencies, including inverse IOs, and $1.2 billion in non-Agency securities for about an 80-20 asset split. By comparison, our capital allocation was roughly 55--45 split in favor of agencies at December 31, which was comparable to the third quarter.

The capital allocation figures include applying leverage in the range of six to seven times for Agency and one to 1.5 times for non-Agency. By comparison, our aggregate portfolio had debt to equity ratio of 4.5 to 1 at yearend, in line with our expectations and the third quarter.

Our Agency holdings are shown on the top right of slide ten. We continued to maintain a portfolio containing significant prepayment protection. For the fourth quarter, our Agency CPR was only 5.6%, which aligns with our average for the full year.

While we believe prepayments in 2012 will pick up, due to both the lower interest rate environment and from the influence of policy initiatives, we believe that our holdings are unlikely to experience a significant increase in refinancing, based on the nature of the investments we have made.

Turning to the non-Agency market, in the fourth quarter, we utilized a similar strategy as in the third quarter. We continue to favor subprime bonds, which comprised over 75% of our non-Agency portfolio. We held both senior and mezzanine bonds, and these bonds were a key driver in our nearly 10% yield on non-agencies in the quarter. As you may have noted on the prior slide, our financing cost on these bonds is a bit over 2%. The appendix includes some additional slides on our Agency and non-Agency holdings that you might -- may find useful.

Please turn to slide 11. You will see on the left some key metrics of our portfolio. We continue to maintain a relatively low level of interest rate exposure. For the fourth quarter, the estimated variance in equity for an up 100 interest rate move is only 2.3%. We added some two year swaps during the quarter, but overall, our position did not change significantly from the third quarter. Our average pay rate on swaps, as you can see on the top right, as of quarter end, was below 1%.

Finally, we maintained 40% optional protection, which has substantially less -- while -- excuse me. While we have maintained 40% optional protection, we have substantially less premium at risk, as most of our swaptions are designed to protect against much higher rates than we have today. More details on our swaps and swaptions are also included in the appendix.

As Brad discussed, liquidity management remains an important component of managing our portfolio. During the third quarter, we continued to focus on long dated repos, and at yearend, 23% of our RMBS borrowings have maturities over 90 days. While this is a lower percentage than in the third quarter, it is worth noting that we have added two year repos for our non-agencies. This longer term funding is ideal for the types of assets

©2012 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

THOMSON REUTERS

we have acquired. Additionally, we decreased our US Treasury versus swap position by $500 million, taking some profits, given the widening of the two year swap spread during the quarter.

Now, I'd like to bring you up-to-date on the market and deployment from our recent our offering. First, the market. Market conditions have been favorable. The Fed's announcement to keep interest rates low until late 2014 is very favorable for our business, and Europe, while not solving their structural problems, has at least found a temporary solution for their financing and liquidity. This bodes well for the financing market and has calmed fears about the deleveraging that European banks may have needed to do if the solution was not found.

Agency spreads during deployment have been attractive, due to contained prepayment speeds and extremely low funding and hedging costs. Non-Agency loss adjusted yields have been attractive on both an absolute and relative basis. As Tom mentioned, we are pleased to have substantially deployed the capital from the recent offering. Typically, our deployments have taken one to two months. We have substantially completed this one more quickly, due to opportunities in the markets, specifically on the non-Agency side.

Trading volumes in January were particularly high and enabled us to take advantage of opportunities in that segment of the market. As we discussed at the time of our capital raise, we intended to weight our January deployment more towards non-agencies, which we believe could produce yields in the low double digits. We are pleased to have purchased non-Agency assets consistent with this expectation.

On the Agency side, as you might expect, we focused on securities with prepayment protection. Low loan balance pools and Ginnie Mae HECMs have continued to look attractive, and we have added in both those sectors. Because this offering was weighted more toward the non-Agency sector, you can expect our overall capital allocations to non-agencies to tick up slightly from the 45% range as yearend.

Our portfolio performance is off to a good start in 2012. Since the end of 2011, the market has seen a general improvement in pricing in non-Agency RMBS markets, with tighter bid offer spreads and an increase in overall demand. Two Harbors' non-Agency portfolios, including the more recently purchased securities from our January offering, have performed well during this period, leading to a moderate increase in book value in 2012. We would like to note, however, that while our non-Agency portfolio and book value has risen since yearend, it is still very early in both the quarter and the year.

We feel very good about our portfolio, including the recent deployment, and, as always, we'll continue to be opportunistic in our approach to the market. I would now like to turn the call back to Kevin for the Q&A.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Our first question comes from Mark DeVries with Barclays Capital.

Mark DeVries - *Barclays Capital - Analyst*

Yes, thanks. Bill, could you talk about how some of the REITs, in changes to HAMP may impact your non-Agency holdings?

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Hey, Mark. Good morning.

Mark DeVries - *Barclays Capital - Analyst*

Morning.

©2012 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

THOMSON REUTERS

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Yes. So, there's been a couple initiatives -- actually, probably more than a couple. So, let me just address a couple things. First of all, the proposal to allow borrowers that are not GSE borrowers to refinance, which, clearly, would affect non-Agency. That would be, obviously phenomenal for our non-Agency portfolio, given the average dollar price on our bonds is about $0.55 on the dollar.

That being said, that kind of a program appears to need congressional approval to get passed, so we actually think that, at least, for 2012, before the election, it's probably a very low likelihood, but it's obvious that the intent is to encourage borrowers to have the ability to refi. So, I would say to the extent anything does come of that, whether it's this year or in the future, would clearly be a boon for our non-Agencies.

The other program -- the HAMP adjustment, which, basically, allows borrowers who are either in imminent default or have different mark-to-market to access, is geared towards GSE loans. The reality is that GSEs are already buying out loans that are either in default, or imminently -- so, at 120 days. So, we actually don't think that that program -- while it will be good for borrowers, we don't think it will actually have much effect on Agency space.

Mark DeVries - *Barclays Capital - Analyst*

So you don't think the tripling of the incentives on forgivenesses is likely to have much of an impact on the way that servicers of non-Agency loans are approaching modification?

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

No. We do think it will, if you -- what we do is we look into each deal, and a lot of the borrowers -- it's unclear how many of the borrowers it will reach, but if it reaches 10% of a pool, and we think they are going to be incented to do this, that, obviously -- if you can refinance 10% of a pool, at $0.50 on the dollar, that's obviously worth five points. We just think it will take a while, and we don't have real good clarity on how much that impact will be. I will tell you that in the market, there is very little credence being given to it in pricing. So, we view it, really, more as an upside positive option than something that we're counting on.

Mark DeVries - *Barclays Capital - Analyst*

Okay. Got it. And I think you kind of alluded to this in some of your previous comments, but we're hearing that -- particularly, with some of the concern out of Europe [inaudible], that money that's been on the sidelines just kind of coming forward and increasing demand in the non-Agency space. Are you seeing that kind of impact -- the potential returns that you can generate, or are they still -- if you raised money again today, would you still be looking at kind of low double digit yields on where it asked for pricing right now in the market?

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Yes. I mean, the market has definitely improved since year-end, and I would say, as of the end of January, non-Agency bonds are more high single digits than low double digits. So, yes, I think that the combination of the comments that you made, as well as money that has been raised to take advantage of the opportunity that we saw that we raised money for, has definitely improved the tone and the pricing in that market.

So, I'd say that the levels that are out there now are definitely tighter, but, still, if you compare to almost anything else that's available -- in an interest rate environment where the ten year Treasury is below 2%, and most other fixed income assets yield 6% or less, yields of 7%, 8%, 9% are still appealing.

©2012 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

Mark DeVries - *Barclays Capital - Analyst*

Right. Okay. And then, what kind of leverage do you expect to apply to the latest non-Agency purchases?

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

We're -- we continue to be comfortable with leverage in the 1 to 1.5 times, and we intend to stick with that.

Mark DeVries - *Barclays Capital - Analyst*

Okay. So that implies 20% plus ROEs on those assets then.

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Yes. I mean, the assets bought in the low double digits that are financed at 2% with that kind of leverage, you could get to those kind of numbers.

Mark DeVries - *Barclays Capital - Analyst*

Okay. Thank you.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thanks, Mark.

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Thanks, Mark.

Mark DeVries - *Barclays Capital - Analyst*

Sure.

Operator

Our next question comes from Jason Weaver with Sterne Agee.

Jason Weaver - *Sterne Agee - Analyst*

Hi. Good morning, guys. This just tails onto Mark's questions with regards to the non-Agency portfolio. I'm just trying to get some more visibility on the book value change, quarter over quarter. Obviously, the synthetic indices on the non-Agency side seem to have bottomed out in November, but I was wondering if you could share what fair value marks you were using on that -- on those portfolios, as well as what you're seeing currently.

©2012 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

THOMSON REUTERS

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Well, this is Tom, and then I'll hand it over to Bill, with respect to market. Obviously, at year-end, we had a very rigorous marking policy, which is that everything that -- which were long is marked for the bid side. Everything over short is marked to the offered side. And so, year-end is reflective of the prevailing market prices in both the Agency and non-Agency space, as well as any derivatives within the portfolio. With the respect to the market since year-end, I'll hand it back to Bill.

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Yes. I mean, one thing -- I mean, just -- I think the -- if I can interpret your question a little bit, the fourth quarter, the ABX and other indices actually outperformed cash bonds. There was definitely concern about potential supply to stress selling, and there wasn't a tremendous appetite by either dealers or investors to add risk in the fourth quarter and particularly, December, onto their balance sheets.

The first quarter, as I mentioned to Mark, that not only has money been raised, not just by ourselves, but some other folks, but also, the funding solution for Europe alleviated a lot of concerns about funding and balance sheet. So, cash bonds had actually performed -- has performed nicely so far this year. But you just have to understand that there is definitely not a one for one movement between indices and cash bonds.

Jason Weaver - *Sterne Agee - Analyst*

Right. It --

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Generally, they move the same way, but not always.

Jason Weaver - *Sterne Agee - Analyst*

And that's what I was actually getting at. Since the initial reaction within ABX, for example, has the basis sort of closed since then or narrowed somewhat?

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Yes. I mean, basically, the -- yes. To that point, the basis disconnected in the fourth quarter and has been much more in line so far this quarter. But I don't think you can necessarily look at ABX and say, hey, it moved a point. That means cash bonds moved a point.

Jason Weaver - *Sterne Agee - Analyst*

No. Of course. That's fair. And just to follow up on that, as that market improves, and investor demand comes out there -- while those are more technical concerns than anything else, how -- or will it even affect your estimate of forward loss adjusted yields on those assets?

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Well -- I mean, we look -- when we look at these assets, we're actually looking on -- at -- on a loan by loan basis and determining what we think the -- projecting the default, the loss severities, and, effectively, the cash flows that it will accrue to any given bond. And so, the market will price them wherever they price them, but in our mind, we're concerned with the fundamental performance, and whatever those cash flows are we'll determine what we think of it, based on where it's trading in the market.

©2012 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

THOMSON REUTERS

So if the market wants to change their assumptions or expect -- accept a lower yield, that's fine. To us, we'll just plug in what we think the real performance will be, because we're looking at this from a long-term perspective, not necessarily from a trading perspective.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Sure. This is Tom, just to chime in a little bit. Obviously, what yields are really determined by -- in the non-Agency space anyway by probability, default recovery, and timing, and obviously, those variables shift over time. For instance, if the housing market improves and recoveries improve, that prices could actually go up and what we perceive yields as could go up as well. So it's something that we evaluate on a continuous basis.

Jason Weaver - *Sterne Agee - Analyst*

Fair enough. All right. Thank you very much, guys.

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Thanks, Jason.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thanks, Jason.

Operator

Our next question comes from Trevor Cranston with JMP Securities.

Trevor Cranston - *JMP Securities - Analyst*

Hi. Thanks. Congratulations on a nice quarter.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thanks, Trevor.

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Good morning, Trevor. Thank you.

Trevor Cranston - *JMP Securities - Analyst*

Morning. Most of my stuff has been answered. I was wondering if you could maybe talk a little bit about how you guys are thinking about hedging, given the Fed's comments -- keeping rates low through 2014 and whether or not that impacts how you think about using swaps versus optional protection and things like that.

©2012 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

THOMSON REUTERS

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Yes. Sure. Yes, it's really an interesting time. We're seeing better data sort of on a weekly basis in the US and -- which theoretically would imply rates -- the market would price in higher rates. But the Fed, having announced that they're going to keep rates low for a number of years is obviously the counter to that. So, especially given the low level of rates, despite what the Fed has said, we continue to maintain very low interest rate exposure. As you saw at the -- on slide 11, that up 100, our Agency portfolio would lead to roughly negative 2% mark against book value.

In terms of tactically, we still believe that swap costs on the front end of the curve are extremely low, and there's actually some very nice one way convexity on that, because it's unlikely that rates really go too much lower. And at the same time, we continue to like the swaptions, especially for longer dated parts of the curve in the seven to ten year part, because, frankly, to the extent that the Fed changes its mind and sort of says, look, data is really good. We're in much better recovery. We may do something sooner.

It's our belief that that could potentially trigger a substantial selloff on the longer data part of the curve, and that's why we like the optionality for that to protect us in that event. We're not projecting or forecasting that, but part of the hedging program is to protect against the unforeseen. So that's sort of the way we're thinking about it.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Yes, I think it's important for us, Trevor, not -- we're committed not to lose in our discipline, because it's easy to say that the Feds can be on stand-down forever, but oftentimes, the market gets ahead of the Fed. And so, you can't rely upon policy alone or stated policy. So, we think now is the time to stick very close to home in respect of interest rate exposure.

Trevor Cranston - *JMP Securities - Analyst*

Okay. That's helpful. And maybe, lastly, can you talk about where repo typically was for you guys around the end of the year and kind of the movement you've seen in the markets since yearend?

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Yes. Sure. I mean, repo, in general, kind of -- rates bumped up across the board at yearend -- or, in the last, sort of, six weeks, and it was a combination of two things. First of all, LIBOR having gone up quite a bit in conjunction with the concerns around Europe. And just, frankly, balance sheets -- dealer and bank balance sheets. People are very careful about watching their balance sheets, so repo rates on Agency pools, for example -- sort of, three month repo got up into the 40 basis points range. In some cases, higher than that. Currently, three month Agency pool repo is in the low 30s. So we probably went from the high 20s up to the low -- into the 40s, and now we're back in the low 30s.

On the non-Agency side, we really saw no change in haircuts or spreads, but repo rates were higher just because LIBOR was higher. There was -- so, basically, as -- those are tied specifically to LIBOR. So those repo rates just went up because LIBOR went up.

I'll also remind you that we had $1.5 billion of swaps versus Treasuries in the two year space to protect specifically against that effect, and as that LIBOR reset higher, we received the benefit of that on the LIBOR part of that equation.

Trevor Cranston - *JMP Securities - Analyst*

Yes. Okay. That makes sense. Thanks, guys.

©2012 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

THOMSON REUTERS

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Thanks, Trevor.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thanks, Trevor.

Operator

Our next question comes from Bose George with KBW.

Bose George - *KBW - Analyst*

Guys, good morning.

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Hi, Bose.

Bose George - *KBW - Analyst*

I have a couple of things. First, I just wanted to follow up on an earlier question about prices. I wasn't sure if you said how much cash bonds are up since yearend.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

We did not, Bose.

Bose George - *KBW - Analyst*

Can I get a little color on that?

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Yes. Let me answer your question this way. Because our portfolio, as well as, frankly, anybody else's portfolio -- some bonds are up more than others. Some bonds, if they're front pay bonds, and they're one or two year average life bonds, probably didn't move much at all. So, I think the fairest way to think about it is that if you think about low double digit yields available at yearend, having moved in recently to high single digit yields, it's sort of 100 basis points to 200 basis points, depending on the bonds.

So, I'd say that some of the bonds that are longer duration -- some of the bonds that are shorter duration might only be up a point or two. Some of the bonds that are longer duration -- those could be up five, six, seven points. It's a little bit different -- it's a little bit difficult to attribute what that means to any particular portfolio, because a portfolio, as you know, is a mix of holdings.

©2012 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

Bose George - *KBW - Analyst*

So, that's the next step. Thanks. And, actually, just switching to the Agency. Your Agency yields were down, quarter over quarter, and prepays were up just pretty modestly. So it looks like incremental spreads were lower. And can you just discuss where they are in the first quarter versus what we -- where they were at the end of the fourth quarter?

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Yes. I mean, the -- I -- let me answer your question this way. The -- with your lower rate environment, you get two things going on, right? You get lower yields on assets, and you get lower yields on the hedging side. Right? So, the way that we manage the Agency strategy, which is on a pretty well hedged basis -- effectively, we're looking at what we think the spread is, as opposed to what the yield is, per se. And when we raised money in January, it appeared to us that the Agency strategy, using the six to seven times leverage, was still a high teens ROE, taking fairly low duration risk. And so, we think that that is still -- that's down from the 20 area, but we think that today, that is still -- mid to high teens is still reasonable, the way that we manage an Agency strategy.

Bose George - *KBW - Analyst*

Okay. So, Agency spreads are not too different from where they were, [kind of, the end] --

---

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Yes. I mean, they're -- well, look, they're tighter than they were in the fall. Mortgage spreads have definitely tightened, but they're not unattractive with regard to mid to high teens kind of number.

Bose George - *KBW - Analyst*

Okay.

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

But they're in --

Bose George - *KBW - Analyst*

(inaudible) macro question.

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Sorry?

Bose George - *KBW - Analyst*

Just wanted to get your thoughts on the servicer settlement. Just curious if you thought that would have any impact on the non-Agency market?

©2012 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

THOMSON REUTERS

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Yes. I mean -- I think it's beneficial to -- it's most beneficial to bonds where you have a reasonable amount of borrowers who can take advantage of that and servicers who will actually pursue that program. I think the idea is to make it attractive for the servicer to do so. Like many of these programs, it's sort of like a show me kind of -- it's a show me kind of situation, because we've seen so programs come out that I think the market is hopeful, but not necessarily likely to price anything in until you start to see it.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Yes. I mean, Bose, it's Tom. We think about it as sort of a free lottery ticket that's embedded in the non-Agency space right now. That's how we really think about it. (inaudible) to the extent that it works for bonds in the 50s, it's terrific.

Bose George - *KBW - Analyst*

Okay, great. Thanks a lot, guys.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thanks, Bose.

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Thanks, Bose.

Operator

Our next question comes from Joel Houck with Wells Fargo.

Joel Houck - *Wells Fargo - Analyst*

Excuse me. Good morning. Thanks. Just kind of back to the hedging strategy. I guess the swap commentary is helpful if it's more of a cash flow hedge, but on the swaptions, it's our understanding that that is used to protect against significant changes in longer rates. Given the lower volatility, what have you guys done in terms of the swaptions book, and how do you think about that? I guess it was Tom that said the market gets ahead of the Fed, and this is one of those instances where volatility is low now.

But, as we all know, people lose confidence in US dollar and things like that, you could have a sharp rise in rates, and it would seem that the swaptions book is really the only way to really protect the book value against those sharp rise and longer rates. So how do you think about that, and what have you done, to that end, to protect book value?

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Yes, sure. Yes, I mean, you're absolutely right. I mean, if you get a chance to look at slide 17, which is in the appendix, you'll see that we have $7.4 billion, roughly, of notional amount of protection on our book, which, if you think about how much repo we have, that's obviously an extremely high number on that relationship. And most -- mostly, we're protecting on a swap basis on the shorter end, but on the longer end, we have almost $3 billion of swaptions, and about 40% of them are longer than six months expiree, with a strike of only 3.2. So, while 3.2 sounds like it's a long way away now, it might not be a long way away in that scenario you described.

©2012 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

The way we manage the book and the way we think about it is, on a daily basis, we track our exposure, and we make any adjustments that we feel are necessary to keep our duration in line with our targets. So, with regards to December 31, you can see where we were on slide 17. With regards to our raise in January, we think about it the exact same way, so, to the extent that we added Agency assets as part of that capital raise, which we obviously did, you can expect to see hedges that would be similar to the way I described that we think that were going to accompany those asset purchases.

Joel Houck - *Wells Fargo - Analyst*

And, Bill, do you -- when volatility comes down, and hence, the premiums are cheaper, do you look to add, or do you kind of keep a constant ratio in terms of the swaptions to the asset book?

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

No. I mean, the fact -- look, one of the reasons mortgages have done well through the end of the year and into the -- this part of the first quarter is because volatility has come down. So, even though you get less spread and yield from Agency pools, the reason is because the options you're short, that volatility is so much lower.

So, as a result, using -- buying back that optionality -- that's why I mentioned before we think the Agency strategy returns are roughly -- are still attractive, because it is much cheaper to buy options today. So we don't have a problem doing that. We do do it, and we do it particularly on the longer part of the curve, because if something were to happen that you described, that's the part that's going to get hurt.

Joel Houck - *Wells Fargo - Analyst*

All right. That's a great explanation. I guess the last thing I had is kind of back on the non-Agency refi proposal. I guess -- I don't know if it's part of that broader proposal, but there's some discussion about Obama having Ginnie Mae underwrite jumbo subprime loans, which, I guess, would require funding of FHFA and congressional approval, so does the same commentary apply to that that it's dead on arrival in an election year, or is there something we might be missing if they could back in this without congressional approval?

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

I don't -- yes, I mean, I'm not the political expert, and I'm -- so, I'm not probably quick to answer that, but I think that most market participants and observers believe anything that requires congressional action is unlikely to happen before the election. That being said, it's clear that rates are low, and it's beneficial to borrowers to get -- to take advantage of that. So, I think you'll continue to see effort to come up with ideas and programs, not just before the election, but through and after the election, to enable borrowers to save money. And I think anything that clearly helps the non-Agency side is huge for those type of bonds.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Yes. The other thing that we would add to that -- obviously, that -- since unemployment has fallen somewhat -- still high by historic measures, but definitely lower quarter over -- or, year over year. That, obviously, can be impactful to recoveries and defaults in the non-Agency space. So that's something that we think about, and, in fact, we think that's probably more meaningful than any government initiative in that regard, because, obviously, the LTV is a -- sort of, the penultimate value determinant in the non-Agency space, but employment is very impactful, too. People are much less likely to default homes if they're employed.

©2012 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

THOMSON REUTERS

Joel Houck - *Wells Fargo - Analyst*

Yes. Good point. All right. Thank you, gentlemen.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thank you.

Operator

(Operator Instructions). Our next question comes from Boris Pialloux with National Securities.

Boris Pialloux - *National Securities - Analyst*

Thank you for taking my question. I had, like, two questions. One, regarding your 3.5% asset yield for agencies, and second one, regarding your asset securitization platform. The first one is those 3.5% asset yield -- do you -- looking at page ten of the presentation, is there a specific pool where you have a real drop in assets' yield? And second is regarding the asset securitization platform. One of your peers was very active in January. Are you ramping -- are you going to ramp up that in Q1, or is that more like in -- later in 2012? Thanks.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Sure. Sure. I'll -- this is Tom. I'll answer the securitization question, and then I'll turn it over to Bill, with respect to your first question. How we've thought about this is very simply. Doing a securitization is quite easy. Doing a securitization that is attractive, relative to the non-Agency opportunity that we saw in December and in January, is something completely different.

And so, we don't want to do a securitization simply to do a securitization. We think that it must meet the critical hurdle of being good for shareholder value, so something that we continue to constantly monitor. Obviously, Bill has spoken to non-Agency performance in 2012, the beginning of the year, but that is a benchmark that we're always looking at, in respect to the attractiveness of securitization. It simply must be good for shareholders. Doing a securitization just to do one makes no sense to us. Bill, did you want to handle the first question?

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Yes, sure. Yes. So, actually -- I'm going to actually answer your question in a couple different ways. First, the yield decline on the Agency side was a combination of two factors, and if you slip back to slide nine, kind of, actually addresses it there. First of all, new purchases, because of the lower yield environment, were obviously lower. And the second thing is we had lower realized yield on IO and Agency derivatives, which are IO like securities, due to some faster prepayments there.

That being said, if you look at the bottom chart, you'll see that our annualized yield of 3.5%, and you'll see at the bottom there our net interest spread of 2.6%. That's actually still extremely compelling in the Agency space. If you -- we noted that we run our leverage in the six to seven times, so if you take, let's say, the midpoint there, just as an example, of 6.5 times your net interest spread of 2.6%, and then you add the yield on top, you still end up with an investment ROE of over 20%.

So, while -- and keep in mind, this is for a portfolio that we believe, anyway, is very well hedged, with regards to interest rates. So, while it is true that the returns on the Agency strategy have come down, which I mentioned in response to an earlier question, we still believe that it's a portfolio still quite attractive.

©2012 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.

Boris Pialloux - *National Securities - Analyst*

Thank you.

Bill Roth - *Two Harbors Investment Corp. - Co-Chief Investment Officer*

Thank you. Thanks for your question.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thanks for your question.

Operator

There are no further questions in the queue. I would like to turn the call back to Mr. Siering for closing comments.

Tom Siering - *Two Harbors Investment Corp. - President, CEO*

Thanks, Kevin. Before we wrap up, I just have a few closing comments. This will be Jeff Stolt's final earnings call with us. Jeff, the entire team would like to thank you for your invaluable contribution to Two Harbors in our formative years as our CFO. We look forward to continuing to work closely with you and the Pine River finance team.

Finally, I'd like to thank our shareholders once again for your support. We take our responsibility to you quite seriously. Thank you for attending today's call, and have a great day.

Operator

Ladies and gentlemen, this concludes your conference for today. You may disconnect, and have a wonderful day. Thank you for participating.

DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2012, Thomson Reuters. All Rights Reserved.

©2012 Thomson Reuters. All rights reserved. Republication or redistribution of Thomson Reuters content, including by framing or similar means, is prohibited without the prior written consent of Thomson Reuters. 'Thomson Reuters' and the Thomson Reuters logo are registered trademarks of Thomson Reuters and its affiliated companies.